

Murray Goulburn Co-operative Co. Limited

***Submission to the
Australian Competition & Consumer Commission***

Dairy Inquiry

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Introduction

Murray Goulburn (**MG**) welcomes the opportunity to make a submission to the Australian Competition and Consumer Commission's (**ACCC**) Inquiry into the Australian dairy industry.

This submission provides a brief overview of MG and its position in the Australian dairy industry, and also addresses the issues identified in the ACCC's Issues Paper.

MG considers there is strong competition amongst market participants in the Australian dairy industry. This competitiveness is beneficially influenced by the presence of two co-operative dairy processors in Australia. MG also considers that its own co-operative structure delivers substantial benefits to farmers because maximising farmgate returns is fundamental to MG's ethos.

The Australian dairy industry is significantly affected by global dairy commodity prices and foreign exchange rates, because much of Australia's milk production is exported as manufactured dairy products and substantial volumes of dairy products are imported into Australia.

However, with growth in global demand for dairy products projected to outstrip supply into the medium to long term future, particularly in Asia, the Australian dairy industry is well placed to supply, and benefit from, this increased demand.

Murray Goulburn

Murray Goulburn Co-operative Co. Limited

MG is Australia's largest dairy foods company. It is 100 percent dairy farmer controlled, with approximately 2,200 farmer-supplier shareholders. All suppliers are required to hold shares in MG.

In FY16 MG acquired approximately 3.5 billion litres or 36.6 percent of Australia's raw milk and generated sales revenue of approximately \$2.8 billion. Approximately 60 percent of that revenue was generated from sales of dairy products and drinking milk in Australia and the other 40 percent was generated from sales outside Australia. As the country's largest dairy foods exporter, MG accounts for approximately 50 percent of Australia's dairy exports. It sells to the major markets of Asia, the Middle East and North Africa, and the Americas. MG has played a significant role in developing export markets for Australian dairy producers.

MG produces a full range of dairy foods, including drinking milk, milk powder, cheese, butter and dairy beverages, and a range of ingredient and nutritional products, such as infant formula. It supplies the retail and food service industries globally with products under its flagship Devondale, Liddells and MG Ingredients brands.

MG is a major employer in regional Australia and a significant contributor to rural economies. It employs approximately 2,350¹ people based at 10 processing plants, ancillary businesses (including MG Trading stores) and corporate offices located across Victoria, New South Wales, South Australia and Tasmania. After milk payments to suppliers, MG's corporate income tax contribution in Australia during FY15 was \$12.4 million. In FY16 MG paid payroll tax of approximately \$13.0 million. Salaries and wages in FY16 amounted to approximately \$253.5 million and employees contributed PAYG tax of approximately \$72.2 million.

¹ Employee numbers are expressed on a Full Time Equivalent (FTE) basis (as at 11 October 2016).

A map of MG's milk collection regions and processing facilities is provided at Attachment A.

MG's Vision and Strategy

MG's vision is to be a 'first choice dairy foods company' for farmers, customers and consumers.

Our strategy focuses on two key areas²:

Operational excellence – invest in modern, flexible and globally competitive dairy foods manufacturing and supply chain infrastructure to deliver and sustain business efficiency and cost leadership.

Innovation – drive the ongoing shift to value-added products in the key growth categories of nutritional powders, consumer cheese and dairy beverages.

Farmer co-operatives

In general terms, co-operatives are business organisations owned and controlled by members for their mutual benefit. While the structure of co-operatives may vary significantly, common elements include that control is in the hands of its members, members are the primary source of equity capital, and returns on capital are limited and allocated on the basis of use. Importantly, the underlying objective of the co-operative is to maximise returns for the members.

Unlike in a conventional profit-maximising organisation, the shareholders of a farmer co-operative are the key suppliers to the business and have established the business solely for their benefit.

In an agricultural context, farmer co-operatives generally have the following features:

- the cooperative is established with the sole objective of maximising financial returns to farmers, or “valorising” their output;
- membership is open only to farmers who supply the co-operative;
- the co-operative is required to acquire all of a farmer-member's output and the farmer-member is required to supply all of its output to the co-operative;
- farmer-members make ongoing capital contributions, which are redeemable (or the shares transferrable) upon exit from the co-operative;
- farmers receive financial returns through some combination of direct payment for their output and dividends; and
- farmers are involved in the governance of the co-operative.

As a result, farmers have a dual relationship with co-operatives: as owners, who supply capital and are directly involved in governance of the co-operative; and as suppliers in an exclusive supply relationship.

² MG's Annual Report 2016, page 5. Available at www.mgc.com.au

The co-operative structure is uniquely suited to representing farmers' interests. Without collective bargaining, farmers are price takers – they sell a fungible and perishable product to large processor or manufacturer buyers in often concentrated downstream markets. Whilst some co-operatives are pure supply co-operatives and merely collectively market their farmer-members' raw output, more sophisticated co-operatives (such as MG) may also have processing, distribution and marketing operations that allow greater control over returns to farmers.

Co-operatives can protect farmer-members' interests and ensure they receive a fair return (in a way that individual farmers could not) through:

- aggregation and collective marketing of farmers' output;
- allowing farmers to realise a greater value for their output by integration into the value chain, such as by operating transport, storage or processing infrastructure; and
- diversification of income streams by dealing with multiple buyers and across several products.

Incentive structures and co-operatives

In the procurement of raw agricultural commodities, the incentives of, and constraints upon, co-operatives are fundamentally different from conventional profit maximising organisations.

Incentives to maximise prices paid to farmers

Co-operatives are established by farmers with the explicit objective of maximising returns to farmers – they have no incentive to reduce prices paid to farmers.

Although there are some differences in payment structures, co-operatives generally calculate the maximum amount they are able to pay for members' output, taking into account:

- the surplus that is to be retained for investment;
- the expected total output of the farmer-members; and
- the revenue expected to be earned in downstream markets.

For this reason, in markets in which they operate, the prices paid by co-operatives often set the “benchmark” price against which non co-operative buyers are forced to compete in order to obtain supply.

In contrast, conventional profit-maximising organisations necessarily seek to minimise prices paid to farmers, as input prices represent a key cost of production and often have a substantial impact on the profits available to pay shareholders.

Lowering farm gate prices hurts farmers and co-operatives

The surplus earned by a co-operative is either:

- used for investment in the co-operative's processing and marketing activities to ensure there is ongoing demand for the co-operative's goods in downstream markets and to help lower the cost of production in the future (or avoid future increases in costs) – all of which ultimately benefit farmer-members by allowing for more funds to be available to pay for milk in the future. This investment may also be quite broad. For instance, as retail milk prices are variable, co-operatives “insure” farmers to a degree from risk and require reserves to do this; or

- returned to farmer-members through a dividend.

There is a direct trade-off between a relatively high surplus and relatively higher milk prices. As a result, co-operatives have no incentive to reduce raw milk prices simply to increase profitability – this is effectively taking with the left hand and giving back with the right.

In addition, lowering raw milk prices not only changes the “flow” of cash (from milk payments to profit), it also distorts milk production. Facing low prices, farmers would produce less milk and may even be forced to leave the industry or convert to other commodities. This is completely inconsistent with the goal of co-operatives of maximising returns to farmers. The only way this goal can be achieved is by maintaining a competitive farm gate price for milk.

Instead of seeking to enhance profitability by cutting raw milk prices, co-operative management (and the farmer-representative board) focuses its attention on maximising profitability through:

- reducing the costs of non-agricultural inputs;
- increasing efficiency in production; and
- effective product development and marketing in downstream markets.

Disciplines on co-operative governance

The board of co-operative organisations is appointed by shareholders (the farmer-members) to represent their interests. There is no reason for co-operative boards or management to act other than in a way that enhances returns to farmer members – either in the short or long run.

As in any organisation where ownership is separated from management, the ultimate discipline on board governance is the possibility that directors will be dismissed by shareholders. Most co-operatives have various processes that facilitate member involvement in the governance of the co-operative (such as elections, farmers representation on the board, management reports etc).

Indeed it could be argued that farmers are more likely to be active and involved shareholders in a co-operative when compared to shareholders in a listed company. The farmers have a direct interest in their co-operative’s operations as it affects their livelihood and main business activity – unlike an ordinary shareholder in a listed company.

Recognition of the importance of co-operatives

Earlier this year, the Senate Economics Reference Committee Inquiry into Co-operatives and Mutuals (March 2016³) recognised the important role that co-operatives play in the Australian economy, particularly in the agricultural supply chain. MG is one of two Australian dairy farmer-controlled processors operating in Australia (the other dairy farmer-controlled processor is Norco, which operates on the north coast of NSW).

The presence of strong co-operatives is common in successful dairy industries around the world. A European Commission report published in 2012 found that in “EU countries where dairy cooperatives have a large market share, farmers receive a higher milk price than in

³ Senate Economics Reference Committee (2016), *Final report on the Inquiry into Co-operative, mutual and member-owned firms*, March.
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Cooperatives/Report

countries where cooperatives cover a small share of the dairy market”⁴. Their econometric analysis of different milk price data demonstrated that moving to a co-operative market share of 20-50 percent increases the relative milk price by more than 15 percent, when compared with a 20 percent and below co-operative market share⁵.

An important distinction concerning the drivers of business priorities can be made between co-operatives and companies that operate for profit. This is summarised in the following comment by Mick Keogh (2013)⁶:

“A co-operative exists for the benefit of its members, while a company exists for the benefit of its shareholders. So while a dairy cooperative might pay a quite high price for milk and forego some co-operative profits in order to bring benefits to dairy farmer members, a company is, by law, required to maximise its returns for shareholders. This means it will try to maximise the net margin between the price it pays dairy farmer suppliers, and the price it receives when it sells products to consumers.”

MG Unit Trust

Although MG listed a unit trust on the ASX in July 2015, this was a capital raising to support MG’s investment strategy. MG itself is not a listed company and continues to operate on the co-operative principles enshrined in its constitution, with farmer-members continuing to have 100 percent control. As further described in response to question 5 below, the payment of distributions to holders of units in the MG Unit Trust is directly linked to the level of the milk price paid to farmer-members. This aims to align the interests of unitholders and farmer-members.

Responses to the ACCC Issues Paper

Issue 1: Competition for milk

1. The level of competition between processors for the acquisition of milk, across regions

Dairy processors and milk brokers acquire raw milk directly from dairy farmers. Dairy processors also regularly acquire bulk raw milk from brokers and other dairy processors (i.e. from those who conduct milk brokering activities). MG considers that the acquisition of raw milk from dairy farmers and the supply of bulk raw milk by dairy processors and milk brokers form part of the same product market. That is, these transactions are merely two sides of a single product market, because all transactions involving raw milk involve a party supplying raw milk and a party acquiring raw milk.

The raw milk produced on dairy farms varies from farm to farm in terms of milk solids content and quality. Milk quality is assessed and valued based on the percentage of protein and fat solids that it contains, and on the level of bacteria or other contaminants that are present.

⁴ European Commission (2012), *Support for Farmers’ Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.

Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

⁵ European Commission (2012), *Support for Farmers’ Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.

Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

⁶ Keogh, M. (2013). *Australian farmers generally refuse to be cooperative*.

<http://www.farminstitute.org.au/ag-forum/australian-farmers-persistently-refuse-to-cooperate> (as at 6 October 2016).

Dairy processors who acquire raw milk tend to offer price structures that take into account these differences in milk solid content and the quality of the milk being purchased. That is, a 'quality adjusted' price is paid for lower quality milk, because competition occurs on both price and non-price dimensions. Accordingly, all qualities of raw milk are close substitutes for each other.

Other milk processors in the Northern Victoria/Southern NSW, Western Victoria/SA and Gippsland regions usually offer milk price structures to dairy farmers that are similar, but not identical, to MG's milk payment system. There are sometimes differences in prices between regions, which is usually due to variations in farm productivity and milk quality rather than differences in milk payment systems or the prices offered by processors in those regions. Where this is not the case, and there are differences in pricing structures, those differences are usually due to the kinds of end products that different processors have chosen to supply.

Over the past decade, raw milk production in Australia has been declining. Yet at the same time, Australia's per capita milk consumption has been increasing, and to the best of MG's knowledge, many dairy processors have excess capacity. These circumstances have intensified competition between dairy processors for the acquisition of raw milk.

MG considers that competition for acquiring raw milk is strong and this can be seen in supplier movements between dairy processors. While competition is often particularly intense during periods of falling milk supply, there is always a significant threat of farmer switching. The recent milk losses MG has experienced this year are evidence of these high levels of competition.

2. The ability of producers to switch between processors or other buyers

The large majority of MG suppliers, currently representing approximately 76 percent of MG's milk, supply milk under MG's Standard Milk Payment Terms and do not have a fixed term contract. They are free to leave MG at any time to supply another processor.

The remaining approximately 24 percent of MG's milk is supplied under fixed term contract arrangements that range between one and five years. Approximately 40 percent of this milk is supplied under fixed term contracts that arose as a result of supplier participation in the Supplier Share Offer (SSO) during MG's capital raising in 2015. As part of the SSO, new and existing suppliers were invited to purchase MG shares at a discount and in return signed agreements to supply MG for periods of between one and three years. The terms of those fixed term supply contracts were explained in the 2015 SSO prospectus. The remainder of these fixed term contracts arise as a result of commercial business arrangements. For example, certain suppliers receive payments from MG under MG initiatives to support expansion and growth in their farm businesses. The length of these contracts varies from one to five years.

Issue 2: Contracting practices

3. The different types of supply contracts used across the supply chain and in certain regions

MG operates Standard Milk Payment Terms in each of its Southern Milk Region⁷ and NSW-Sydney Milk region⁸. These documents set out the terms and conditions on which MG purchases raw milk, including pricing arrangements, and are published annually.

The Southern Milk Region covers suppliers in Eastern South Australia and western dairy region in Victoria ('**West**'), the Gippsland dairy region in Victoria ('**Gippsland**'), the Murray dairy region in central and northern Victoria and southern NSW ('**North**'), and from 1 July 2016, Tasmania. The Southern Milk Region represents the terms and conditions for supply for the majority of the milk supplied to MG and the milk from this region is processed into the wide range of dairy products supplied by MG.

The NSW-Sydney region comprises the South Coast of NSW, Southern Central Highlands, Central West, Northern Tablelands, Hunter Valley, and Manning Valley.

The milk payment system that MG offers in the NSW-Sydney region differs from the one it offers in the Southern Milk Region for the following reasons:

- New South Wales milk production is largely used by dairy processors for supplying daily pasteurised drinking milk, and they require a certain, year round, flat (as opposed to seasonal) supply of milk. As a consequence, dairy processors in central and northern New South Wales pay a higher price for milk than in southern New South Wales and Victoria in order to incentivise suppliers to produce a largely flat milk supply (which results in a higher on-farm production cost); and
- Coles pays MG (under MG's contract to supply Coles with private label pasteurised drinking milk in New South Wales) a price that is based in part on the raw milk prices prevailing in the New South Wales-Sydney region.

However, after adjusting for transport costs from Victoria, raw milk prices in the New South Wales-Sydney region would be similar to raw milk prices in the Southern Milk Region.

Further, as discussed in response to Question 2 above, MG has a number of fixed term contracts that include additional terms or varied terms.

4. Concerns about anti-competitive conduct or unfair trading practices, including unfair contract terms.

MG is actively participating in a range of ongoing industry led discussions regarding contractual and pricing arrangements. MG is committed to working with its farmer suppliers and industry groups to continue to improve upon milk supply arrangements where possible.

This has included meetings with farmers groups such as the United Dairyfarmers of Victoria (UDV) and the Australian Dairy Farmers (ADF), and also through MG's attendance at the symposium chaired by the Deputy Prime Minister, the Hon Barnaby Joyce MP, in August 2016⁹.

MG was also represented at an ADF meeting on 27 September 2016 that brought together State Dairy Farming Organisations and processors to discuss the development of a

⁷ MG Supplier Handbook, Southern Milk Region 2016/17.

http://www.mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf

⁸ MG Supplier Handbook, NSW-Sydney Milk Region 2016/17.

http://www.mgc.com.au/media/36239/2016_17nsw_smr-supplierhandbook.pdf

⁹ Deputy Prime Minister's media release, *Working together to tackle dairy challenges*. 26 August.

<http://minister.agriculture.gov.au/joyce/Pages/Media-Releases/working-together-to-tackle-dairy-challenges.aspx>

voluntary Code of Practice¹⁰ to facilitate an improved business relationship between dairy farmers and processors. In addition, there was discussion at that meeting about the transparency and operation of supply contracts with processors¹¹.

MG will continue to play an active role in industry discussions relating to supplier contracts and pricing transparency to support Australian dairy farmers into the future.

MG has already undertaken a comprehensive review of the Standard Milk Payment Terms for compliance with the Unfair Contract laws which came into effect on 12 November 2016. MG considers that the terms and conditions it offers comply with these requirements.

Issue 3: Transparency and price signals

5. How farmgate milk prices are set and communicated to producers

Milk is generally acquired from farmers under two types of commercial arrangement – direct contracts or informal “opening price /step-up” payment systems.

For many years MG has adopted the “opening price /step-up” model. Under this approach MG announces to suppliers an opening milk price that is lower than its forecast final milk price for the year. This gives MG an ability to vary the milk price as the year progresses. This process is explained in detail below, along with a brief mention of the alternative direct contract model adopted by some milk processors.

Direct contracts

Under direct contract arrangements processors typically enter into annual or multi-year contracts with farmer suppliers. These contracts set out:

- the volume of milk that a farmer must deliver over the course of a year;
- allowable variations in daily milk supply volumes;
- the specific prices that will be paid for milk deliveries (either on a fat and protein content basis or cents per litre); and
- various price penalties and incentives that will apply in relation to milk quality and the under/oversupply of agreed milk volumes.

Opening price / step-up payment arrangements

MG operates under an opening price / step-up milk pricing model. This model has been common across the industry, particularly in the Southern Milk Region, is well understood by suppliers, reflects the co-operative structure and is designed to manage market volatility.

Other larger dairy product manufacturers such as Warrnambool Cheese and Butter, Bega and Fonterra also adopt this pricing model.

Under opening price / step-up payment arrangements:

- processors implicitly agree to pick up all milk produced by supplier farms during a season if it meets agreed quality standards;

¹⁰ UDV media release (2016). *Dairy farmers champion transparency in proposed industry Code*. http://www.vff.org.au/vff/Media_Centre/Latest_News/Media2016/Dairy_farmers_champion_transparency_in_proposed_industry_Code.aspx

¹¹ ADF media release (2016). *ADF held important meeting with dairy leaders*. 29 September. <http://www.australiandairyfarmers.com.au/media-releases>

- before each production season commences in July, processors announce their opening price. This includes a monthly schedule of the prices they will pay for the fat / protein components of delivered milk over the year. The price offered varies between months with higher payments offered for milk deliveries in the traditionally low production months of autumn and winter;
- the schedule also sets out the potential premiums that will be paid to farmers if milk reaches certain quality standards, if supply exceeds certain seasonal volumes, other seasonal incentives and the deductions processors will charge in relation to milk collection and freight costs; and
- during the course of a season processors announce additional amounts (step-ups) that they will pay for fat and protein deliveries as the year develops and returns materialise. The higher prices are generally applied retrospectively to any milk already delivered during the season as well as any subsequent milk deliveries.

Under these arrangements opening prices are set based on the forecasted average returns on all product sales in all markets, both domestic and export, over the coming financial year. Processors tend to set opening prices conservatively as milk payments to farmers are often made in advance of actual product sales (up to 12 months or more in the case of cheese). Processors announce and pay step-ups as the season evolves and they have better data on actual production volumes, product mix, sales volumes, market developments and return and currency movements.

While the usual approach under this pricing model is to see step-ups during the course of a supply year, inherent within the model (and the sharing of risk which it involves) is the risk of step-downs. These are very rare but can have a significant impact on farmers. There have been two recent examples of step downs:¹²

- **GFC impacts 2008/2009:** Following the adverse impacts of the 2007 drought on farm income and production, world dairy demand and prices rose. This led to higher price expectations for FY09. Unfortunately the global financial crisis severely impacted export prices and led to a number of milk processors announcing a milk price "step down" for the second half of the 2008/09 season. This resulted in milk payments for February to June deliveries to be cut substantially. Despite the necessity of the step downs they were a major shock for farmers and seriously undermined farmer profits.
- **Global impacts 2015/2016:** As a result of a combination of factors including weakness in global milk markets, a strengthened Australian dollar and lower than forecast sales of adult milk powder sachets to China, in April 2016 MG announced a reduction in its milk price, together with a milk supply support package. Some other milk processors also announced step downs.

Benefits of MG's pricing model

MG's pricing model has significant benefits to suppliers. In particular, MG's ability to vary the milk price as the year progresses means that the upside benefit of forecast or improved market returns can be returned to farmers sooner, through the milk price, instead of through dividends after the end of the financial year. This is a significant benefit to farmers' cash flow.

In exchange for sharing in this upside, MG's suppliers share some of the risk of reduced market returns occurring, in that MG could, if necessary, reduce the milk price during the

¹² The only other example of a step down was prior to deregulation and occurred due to a prolonged drought in 1972.

year. This is important, because if MG were not able to do this, it is likely that MG would need to pay a milk price for the whole year that was lower than its forecast. This would result in lumpy returns to farmers that could be detrimental to their cash flow.

MG has historically endeavoured to mitigate this downside risk to farmers by announcing a forecast full year milk price and then paying 90-92 percent of the forecast full year milk price as the opening price to support supplier cashflows. That is, MG pays the opening milk price to its suppliers from the start of the financial year. It is rare that MG needs to lower its opening milk price with only three occasions where this has occurred in MG's 65 year history.

Market risk is managed in other major dairy export regions differently. In New Zealand the opening price is traditionally a smaller percentage (between 60-70 percent) of the forecast final farmgate price. However, New Zealand is unique as Fonterra collects around 87 per cent of the total milk supplied and exports around 95 per cent of its milk production. As a result, there is no 'market price' set through competition for supply¹³.

In Europe farmers are quoted milk prices on a monthly basis, which reduces their ability to generate longer term forecasts across the full financial year.

Whilst this approach might reduce the risk of a price reduction during the season, it also has downsides. If a New Zealand model were adopted dairy farmers would not receive the same level of cashflow at the start of the season as they currently receive under the MG model. Instead they would rely on the forecasted final farmgate being held and then realising a price increase through the year as step-ups.

In Europe farmers are quoted milk prices on a monthly basis, which reduces their ability to generate longer term forecasts across the full financial year.

Due to the competition in Australia for milk it leads to a higher proportion of the forecast full year price being represented in the opening price.

MG historically has usually announced "step-ups" to the base milk price periodically throughout each financial year. When determining whether to make a step-up, and if so, the size of that step-up, MG takes into account the following factors:

- MG's delivered sales as the year progresses;
- updated expectations about the foreign exchange;
- updated expectations about the commodities market; and
- any other matter that affects MG's initial budget forecast (for example, revised milk intake volumes, revised operating costs, etc).

There is no pre-determined timing for MG's step-ups and they are not guaranteed.

When MG announces a step-up, it usually applies it retrospectively for farmer suppliers who are continuing to supply MG at the time of the step up. That is, MG applies the increase in price both to ongoing volumes of milk supplied during the remainder of the year and to milk volumes already supplied since the start of the financial year.

Profit Sharing Mechanism

In conjunction with the listing of the MG Unit Trust in July 2015, MG introduced a profit sharing mechanism (**PSM**) to govern the setting of the Southern Milk Region farmgate milk price and the amount of Net Profit After Tax (**NPAT**) to be available to be paid as dividends

¹³ Source: <http://www2.fonterra.com/our-financials/farmgate-milk-prices> (accessed on 11 October 2016)

on shares and distributions on units, as well as the allocation of the milk pool to income tax. The allocation between milk payments, income tax and NPAT is based on the size of the milk pool and the volume of milk supplied in the Southern Milk Region.

The PSM aims to align unitholders and suppliers' economic interests by linking the dividend rate to farmgate milk price. In summary:

- when the farmgate milk price is relatively high, MG will allocate a higher proportion of the Milk Pool to NPAT available for dividends to Shareholders and distributions to unitholders; and
- when the farmgate milk price is relatively low, MG will allocate a lower proportion of the Milk Pool to NPAT available for dividends to Shareholders and distributions to unitholders¹⁴.

MG's primary objective is to maximise farmgate returns for farmer-suppliers via farmgate milk price and dividends. In FY16, MG paid 96.5 percent of the milk pool to milk payments and income tax and 3.5 percent to dividends / distributions.

In FY16, the NPAT attributable to shareholders and unitholders was \$40.6 million, with supplier shareholders receiving approximately two-thirds, which recognises the value of the capital that suppliers have invested in MG over many years, and unitholders in the MG Unit Trust the remaining third¹⁵.

Structure of MG's Milk Payments

As a co-operative MG invests considerable time and effort in developing its milk payment system to ensure funds from the co-operative are distributed as fairly as possible.

As an illustration, in 2012 MG and the Boston Consulting Group (BCG) undertook a comprehensive review of MG's milk payment structure. The primary objective of the review was to recommend a milk pricing system that was based on fairness and profitability for all MG suppliers across farm systems and regions and allowed MG to develop a sustainable business that maximised the farmgate price for all its members¹⁶.

In undertaking this review MG considered a range of factors, including:

- Supplier opinions about the payment system and its interaction with their farm business decisions;
- Farm production costs across systems;
- The seasonality of milk supply and MG's supply needs;
- The net return to MG of its products across months;
- Competitor pricing and product mix; and
- MG's strategy going forward.

¹⁴ MG Unit Trust, Product Disclosure Statement, page 9.

<http://www.mgc.com.au/media/23437/mg-unit-trust-product-disclosure-statement-29-may-2015.pdf>

¹⁵ MG ASX Announcement (2016), *Murray Goulburn announces results for the Full Year ended 30 June 2016*, page 4.

<http://www.mgc.com.au/media/39102/murray-goulburn-announces-results-for-the-full-year-ended-30-june-2016.pdf>

¹⁶ MG supplier letter re: 'Headline outcomes from MG's Milk Payment System Review', 13 March 2013. <http://www.mgc.com.au/media/4830/MG-milk-payment-review-supplier-letter-FINAL.pdf>

The review included a farmer survey with 580 responses, 16 farmer meetings and direct consultation with several of the industry's leading farm advisers.

The review also examined MG's growth strategy in areas including UHT, cheese, butters and spreads and plans to increase the footprint for Devondale in Australia and overseas. This included an examination of peak versus off-peak returns for MG (the value of milk across months) and the competitive landscape for milk in Australia.

The increasing emphasis of the Australian dairy industry on consumer-pack and value-added ingredients such as infant formula was also noted.

The headline outcomes of the review included:

- Base price and seasonal incentives
 - *A Simpler System* – moving from three base prices to a single base price.
 - *Improve cash flow and profitability* – raise the base price during peak months vs. off-peak months, creating a flatter price curve.
 - *Retain a flatter milk commitment to underpin markets* – retain a simpler flat milk incentive with an improved cash flow structure to ensure MG can supply key markets and increase the milk price for all suppliers.
 - *Balanced* – a milk pricing system that balances the profitability drivers of a range of farm systems and MG product mix objectives – maximising the milk price for all suppliers.
- Fat and protein ratio – a protein to fat ratio that better reflects the increase in market value of fat products, such as butters.
- Productivity incentive, pick-up and volume charges
 - *Fair market signals (milk handling costs)* – the review found that the existing productivity incentive and volume charge fairly reflected the true costs to the MG business and therefore apportioned milk handling costs fairly among suppliers. As a result these were maintained at similar levels but simplified. However, pick-up charges were amended to better reflect true costs.
- Quality – the review recommended changes to the milk quality system, particularly with increased regulatory and compliance changes being introduced globally.

The outcomes of the review were fully communicated to suppliers and were aimed at providing farmers with improved cashflow at the start of the financial year. Following the review MG implemented the majority of recommendations.

Pricing models

As a co-operative, the mechanism of best delivering the distribution of payments from the milk pool will always be a topic for discussion and refinement

MG announced a review of its milk price mechanism at its Annual General Meeting in October 2016¹⁷. The review will be conducted by MG in consultation with suppliers to determine whether the current approach to pricing remains fit for purpose amid ongoing volatility in commodity markets.

¹⁷ MG ASX Announcement (2016), *2016 Annual General Meeting Chairman's and Interim CEO's addresses*, page 3.
<http://www.asx.com.au/asxpdf/20161028/pdf/43cdqg4p41fdxd.pdf>

The Board and management also support the proposed introduction of an Australian commodity milk price index as a way in which to further enhance pricing transparency across the dairy industry. A commodity milk price index should be independently managed and tailored for the benefit of all participants in the Australian dairy industry. A forward focussed index such as the milk futures index run in New Zealand by Agri HQ will allow farmers to better plan for investment on farm.

MG is committed to working with suppliers, State Dairy Farming Organisations, ADF and other processors to improve the industry for all participants and to exploring ideas for improving Australia's national competitiveness and pricing transparency, including the introduction of the proposed commodity milk price index¹⁸.

6. The availability and use of meaningful global market information and price signals across the industry, including by dairy farmers.

The availability of market information regarding global trade in key dairy ingredients has increased in recent years. The development of the Global Dairy Trade (GDT) platform and other reporting platforms has underpinned this increased global market transparency. The media reports on this information and it is readily available to farmers.

Although there is a large amount of information available to dairy farmers, this does not necessarily equate to a full awareness within the sector about the influences on milk price. MG observes a broad spread of understanding amongst suppliers, whereby the divergence includes suppliers with a comprehensive understanding of factors influencing milk pricing as compared to those with a more limited understanding. Programs to improve the knowledge around milk pricing and farm business management capability are important to developing the industry in Australia.

Therefore, despite the increased availability of information regarding global dairy trade, MG believes that a specific Australian dairy index, which uses market data to reflect an Australian dollar farmgate milk price, could add further value to an informed market.

Exposure to export markets, commodity prices and their impacts on value-added product pricing (such as UHT) is a significant external influence on Australian dairy manufacturers who export dairy products. More broadly in Australia, given the strong interplay with world dairy commodity markets, domestic dairy product prices, and therefore the resulting farmgate milk prices, are strongly influenced by international markets and prices¹⁹.

Attachment B provides a comparison between MG farmgate prices and the commodity price for the past 10 years.

Given the volatility in commodity markets and exchange rates it is difficult for processors to accurately forecast farmgate prices beyond the current year. This makes it difficult for dairy farmers to prepare meaningful budgets for the following season until the forecast farmgate price is announced, which due to the competition for milk and market volatility is often not until a few days or weeks before the start of the upcoming financial year.

It is important to recognise the diverse manufacturing footprint that exists in the Australian dairy industry. Approximately 25 percent of Australia's milk production is used to

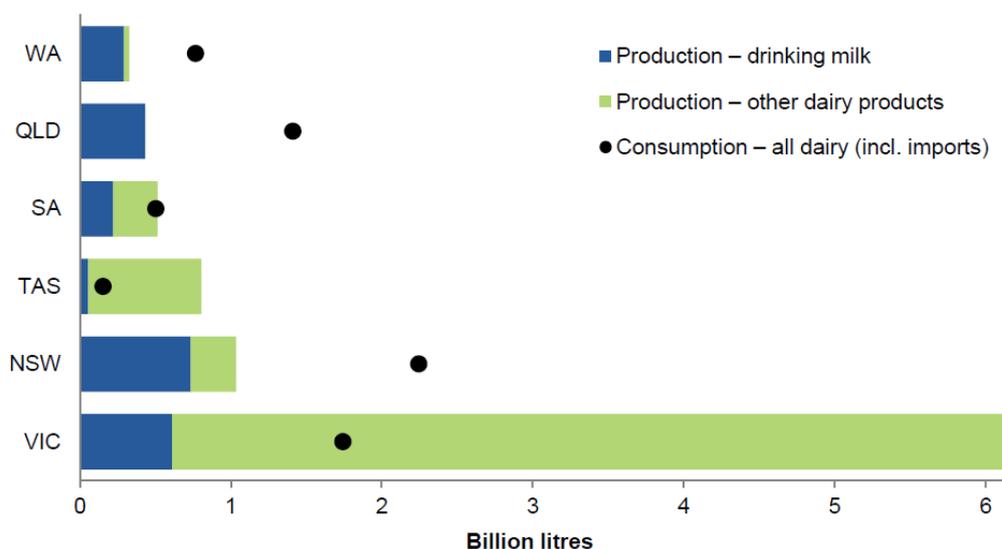
¹⁸ MG Supplier letter dated 16 August 2016.

<http://www.mgc.com.au/media/38622/supplier-letter-post-canberra.pdf>

¹⁹ Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 10

manufacture drinking milk (both chilled and long-life), while the remaining volume is used to manufacture other dairy foods²⁰.

As demonstrated in Figure 1, the majority of the raw milk produced in Victoria, Tasmania and South Australia is manufactured into dairy foods other than drinking milk (such as cheeses, powders and other non-dairy beverage products), and production far exceeds domestic consumption.



^a Production estimates assume all raw milk is used for manufacture in the state in which it is produced. Consumption estimates assume dairy consumption is 301 litres per capita (milk equivalent) in all states.

Figure 1. Production and consumption of dairy goods, by state (Milk equivalent terms, 2013-14)²¹

As the Productivity Commission identified in 2014²², Australian dairy processors will not sell into the domestic market at a lower price than can be obtained in export markets. In addition, competition among domestic processors and from imports ensures that Australian consumers generally do not pay more than the world price (notwithstanding there will be some divergence in prices due to transport costs). It is important to note that dairy product imports into Australia are substantial, with more than 100,000 tonnes of dairy products imported per annum, most of which is cheese from New Zealand²³.

Issue 4: Domestic retail markets

7. The major supply channels for the domestic market, including major supermarkets and other retailers

The major supply channels for the domestic market are supermarkets and food service.

MG supplies to the three major supermarket retailers (Coles, Woolworths and Aldi),

²⁰ Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 34.

²¹ Source: Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 47.

²² Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 60.

²³ Dairy Australia, *Australian Dairy In Focus 2015*. Page 50.

<http://www.dairyaustralia.com.au/Industry-information/About-Dairy-Australia/Publications-2.aspx>

Metcash (which is the major wholesaler to independent supermarkets such as IGA), and to smaller retailers such as Costco, Foodworks, Foodland and SPAR.

Supermarket retailers acquire both private label and branded dairy products. Private label products are supplied to supermarket retailers under contracts that are won through a tender process. Historically, supermarket retailers have requested tenders on a yearly basis, however, more recently, private label contracts have been entered into for longer terms.

In relation to the supply of branded products, supermarket retailers usually conduct an annual or bi-annual 'range review', during which they analyse each product's overall performance and rate of sale to determine whether to retain those products the following year. Deletions are common, even where a branded product has a high level of investment (processing infrastructure and brand investment), high rates of sale and deliver high margins.

MG also supplies food service customers either directly or via buying groups. These buying groups represent food service customers which supply the restaurant, hotel and coffee shop trade. Buying groups negotiate promotions on behalf of the customers they represent.

MG does not generally enter into supply agreements for specified time periods with food service customers, because its dealings are generally transactional and relationship-based. Supply is generally on an 'as needs' basis – that is, as an order by order basis – and MG has to price competitively to secure business.

8. The impact of \$1 per litre milk on the industry. This includes information about the positive and negative impacts of private label product supply contracts.

Retail milk prices in supermarkets are determined by the supermarket retailers. Retail \$1 per litre milk on private label milk was first initiated by Coles supermarkets in 2011. Other major supermarkets soon followed by making similar cuts to their retail pricing⁵⁵.

In April 2013, MG signed a 10-year agreement with Coles to supply its private label milk needs in NSW and Victorian supermarkets from July 2014⁵⁶. The agreement also led to Devondale milk and cheese being stocked in Coles supermarkets. This agreement enabled and prompted MG to invest \$160 million in building a state-of-the-art daily pasteurised milk processing factories in Laverton and Erskine Park⁵⁷. Before that time, MG had limited exposure to daily pasteurised markets via its Kiewa processing site.

The milk price paid to MG by Coles locks in a margin that delivers additional profits to MG farmer-suppliers over the life of the contract. This margin is not affected by price fluctuations in international dairy commodity markets or movements in the Australian currency, and the contract contains rise and fall provisions to protect the margin⁵⁸.

MG has received a better return for the milk solids sold via daily pasteurised milk than it would have received if these solids were sold into many of its other dairy markets.

Coles determines the retail price it charges for daily pasteurised milk supplied by MG.

Issue 5: Global markets

9. Options for supply into export markets, including products and destinations

Global demand for dairy foods is growing steadily, particularly in emerging markets. By 2020, it is expected that Asian import demand will increase by as much as 9.7 billion litres

per annum. The Asian growth markets of China, Japan and South Korea are not self sufficient dairy producers.²⁴

Longer-term outlooks still remain favourable for the dairy sector. Global dairy production is forecast to grow, on average, 1.9 percent from 2014-2023, which is lower than the growth rate experienced in the preceding decade (2.2 percent). However, global dairy demand is forecast to continue to grow over the next decade as higher economic growth will result in consumers looking for additional protein sources²⁵. With the growth in demand for dairy in China and the ASEAN-6 nations (Indonesia, Thailand, Malaysia, Singapore, the Philippines and Vietnam) well above the global average, there is an opportunity for Australia to capture some of this demand. The removal of milk supply quotas in Europe combined with changing demand patterns in China and Asia is also impacting on market dynamics.

Risk management products that could be used to offset this increasing level of volatility (e.g. the NZX dairy futures market) are relatively new and require further depth in trade. MG is keen to support the future development of these products so that it can potentially reduce the future impact of volatility on farmgate returns.

MG also notes that the establishment of key free trade agreements, such as the China-Australia Free Trade Agreement (ChAFTA), will see the phased removal of tariffs across key dairy products from Australia. This agreement is expected to benefit the Australian dairy industry as the sector pursues growth through the increased demand in the Asian region. However, MG also notes that the establishment of the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) has led to increasing exposure to dairy food imports to Australia. In 2014-15 approximately 110,000 tonnes of dairy products were imported into Australia from New Zealand, which represents over 50 percent of the total dairy product imports into Australia²⁶.

10. Any barriers to selling into export markets.

As a significant exporter of dairy products, MG is exposed to several key factors that represent barriers to trade. The major factors are:

- inability to access markets due to trade barriers and quotas;
- internal (domestic) support for competitor dairy sectors that distort the competitiveness of Australian exports; and
- non-trade barriers that place potentially unjustifiable costs on Australian exports.

These factors are well known to the Australian Government through the Department of Foreign Affairs and Trade. MG supports ongoing efforts to remove or minimise the impacts of these key barriers to trade.

Another relevant factor for export competitiveness relates to the Australian costs of doing business. This includes Australia's competitiveness in key areas such as wages and energy.

Fluctuations in Australian dollar exchange rates can also impact on the returns that MG carry on its export sales, particularly given the global dairy trade is predominantly conducted in US dollars. These fluctuations can be volatile and can have a direct impact on the price that MG

²⁴ MG Unit Trust Product Disclosure Statement, pg 13

²⁵ ANZ (2015). *Australian Dairy Industry*, September. Available at www.bca.com.au. Page 3.

²⁶ Dairy Australia, *Australian Dairy In Focus 2016*. Page 50.

<http://www.dairyaustralia.com.au/Industry-information/About-Dairy-Australia/Publications-2.aspx>

receives for its dairy products, the milk price MG pays to its suppliers and the dividends available to its shareholders and therefore, distributions to its unitholders.

Issue 6: Production costs and profitability

11. The key factors influencing the profitability of dairy farms, including costs of production.

Like any business, the success of a dairy farm is based on generating profits, which is the result of maximising income and minimising costs.

Income:

In the case of MG farmer suppliers, their income is driven by the capacity of MG to maximise returns from selling dairy products, which is a combination of international and domestic sales across a broad basket of dairy foods. As a result of MG's exposure to export markets, commodity prices and their impacts on value-added product pricing (such as UHT) are the largest external influence on MG's performance. As Australia's largest dairy exporter, MG is more exposed to movements in global dairy commodity prices and exchange rates than any other Australian processor.

MG also seeks to minimise the cost of processing these products, which in turn maximises the value of the milk pool available to pay out to farmer suppliers, shareholders and unitholders.

The most significant component of a dairy farmer's income is generated by selling milk. All dairy farmers also sell livestock in the form of cows and calves with this income directly linked to prevailing beef markets, which are also influenced by global factors. Although dairy farmers can switch to beef production relatively easily, the key consideration for farmers is the utilisation of their asset base. Due to the capital intensive nature of dairy farming it is therefore not easy for a dairy farmer to switch to beef production given the higher value land and capital commitments in regards to dairy shed infrastructure.

Live heifer exports have also played a significant role in diversifying income risk for dairy farmers. However, trade protocols, increased regulation and global competition have impeded this revenue stream for dairy farmers.

Farm expenses:

Dairy farm expenses can vary significantly from farm to farm due to differences in feed inputs. Grain and hay are the major costs on most dairy farms and the price of these inputs varies with seasonal conditions and global factors. Droughts are a major factor in pushing up input prices for feed. Water pricing in regions such as Northern Victoria and Southern NSW follow a similar trend, because drier seasons limit supply and increase water prices. Another key variable cost is fertiliser which is also impacted by global supply and demand and the Australian Dollar.

Other key expenses for dairy farm businesses include wages, including the complexities associated with the recruitment of skilled and unskilled farm labour; energy; other statutory charges such as property rates; interest rates; and the cost of upgrades to capital such as dairy sheds and machinery. Apart from volatility in global dairy commodity prices, the most significant variable for a dairy farm business is climate. Reduced rainfall and higher temperatures limits the farm's feed production, which means that farmers must purchase off-farm feed, usually at a much higher cost. Similarly, irrigation water also becomes scarce during dry seasons and has the same impact on feed costs. Supporting farmers in risk

managing both their milk income and input costs is a key consideration for the Australian dairy industry.

Future of the Australian dairy industry

MG considers that the long-term outlook for the industry remains positive.

In the short-term, continued oversupply in the global dairy market means a continued contraction in supply is forecast for the Australian dairy sector. Dairy Australia's current forecast for 2016 / 2017 is a reduction in national milk production of 5 percent to approximately 9.06 billion litres²⁷.

However, as discussed in relation to issue 5 of this submission, the longer-term outlook remains favourable for the dairy sector based on slowing global dairy production growth and increasing demand for dairy foods, particularly in Asia. As noted above, the presence of a strong dairy co-operative in Australia has a positive impact on the farmgate milk price when compared to countries without a co-operative²⁸. As a major co-operative and the largest dairy food company in Australia, MG will continue to play an important role in the future of the Australian dairy industry.

MG is well positioned to capitalise on the growth opportunities for dairy products globally. Its strategy sees a focus on pursuing value-added dairy products (that is, achieving a premium above a commodity return for our products). This is a strategy that continues to receive the support from MG's supplier shareholders and unit investors. MG also announced in its full year results for FY16 that the Board and management have also refocussed on execution, encompassing operational excellence, innovation and maintaining a strong balance sheet position.

²⁷ Dairy Australia (2016). *Dairy Situation and Outlook Report – October 2016*. Page 24.

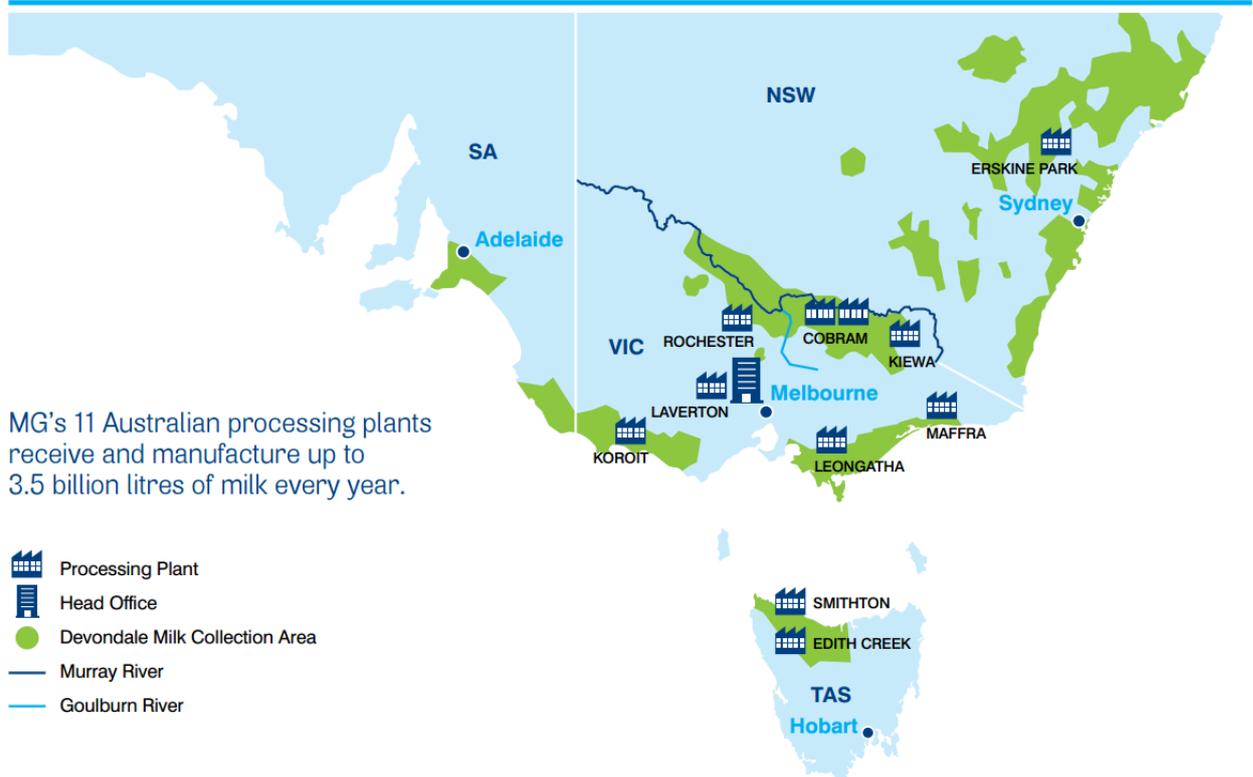
²⁸ European Commission (2012), *Support for Farmers' Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.

Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

Attachments

Attachment A: MG's Australian manufacturing footprint and milk collection regions

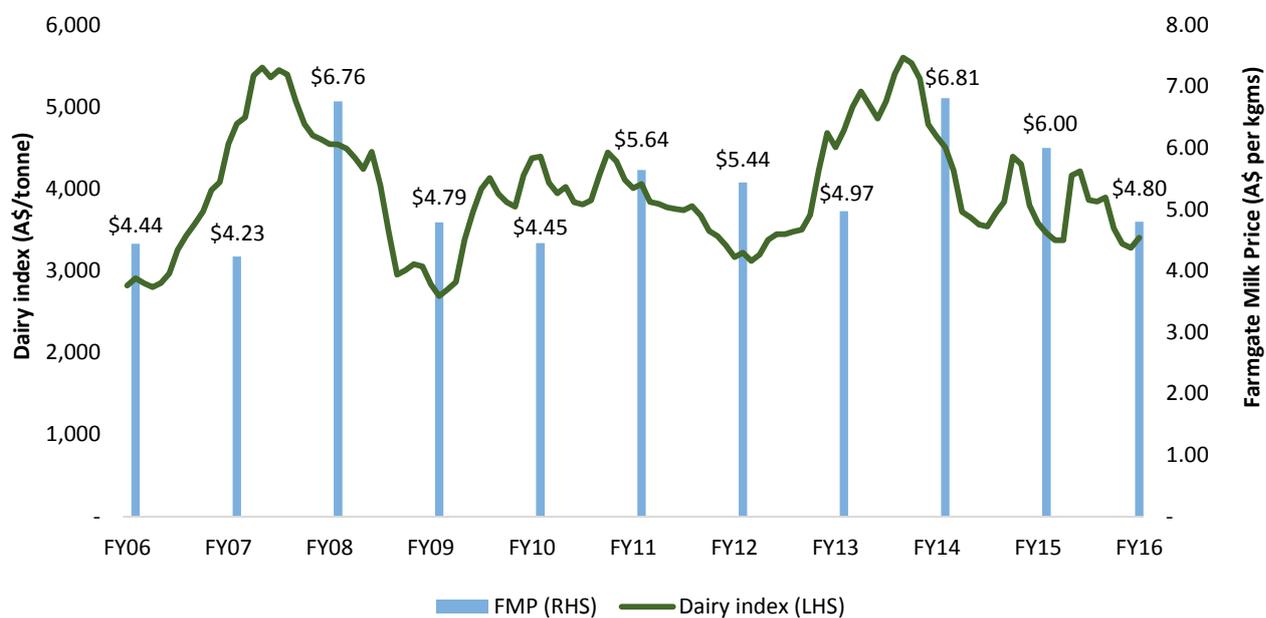
Dairy regions and processing plants



Source: MG's Annual Report 2016 (Page 9)²⁹

²⁹ <http://www.mgc.com.au/media/40795/murray-goulburn-annual-report-2016-web-.pdf>

Attachment B: Historical dairy commodity prices and MG milk prices



Note: Dairy index is calculated as the monthly average of Whole Milk Powder, Skim Milk Powder, butter and cheese pricing from Dairy Australia information, shown with three-month lag.